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DESCRIPTION OF H.R. 6055: SUBCHAPTER S REVISION ACT OF 1982

SCHEDULED FOR A HEARING

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SUBCOMMITTEE ON SELECT REVENUE MEASURES

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INTRODUCTION

This pamphlet provides a description of H.R. 6055 (introduced by Chairman Rostenkowski and Mr. Conable), the Subchapter S Revision Act of 1982. The House Ways and Means Subcommittee on Select Revenue Measures has scheduled a public hearing on the bill on June 14, 1982.

The first part of the pamphlet is a background on subchapter S of the Code. The second part is a summary of H.R. 6055. This is followed in part three by a more detailed description of present law and of the provisions of the bill. Part four discusses some general items for committee consideration. Finally, part five is a statement on the estimated revenue effect of the bill.

I. BACKGROUND

Legislative background

For tax purposes, a corporation is generally treated as a separate entity apart from its shareholders. That is, income earned by the corporation is taxed to it, and distributions from the corporation (either as dividends or in liquidation) also are taxed to the shareholders. A partnership, on the other hand, is not treated as a taxable entity for income tax purposes, but rather the income of the partnership, whether distributed or not, is taxed to the partners, and distributions by the partnership are generally tax-free.

In many instances, businesses, especially small businesses, would like to incorporate for business reasons (for example, to obtain limited liability) but would prefer not to have corporate tax treatment. The noncorporate tax treatment may be preferred where the owners wish to have the corporate losses pass through to their individual returns (or where most of the owners are taxed at individual income tax rates which are lower than the applicable corporate rate). Alternatively, even if the owners are taxed at individual rates higher than the corporate rate, they may prefer noncorporate tax treatment—assuming they expect to withdraw amounts of the income from the business—in order to avoid the "double tax" on corporate distributions.

In light of these considerations, the Congress enacted subchapter S of the Internal Revenue Code (secs. 1371 through 1379) in 1958. The objectives of the legislation were to minimize the effect of Federal income taxes on choices of the form of business organization and to permit the incorporation and operation of certain small businesses without the incidence of income taxation at both the corporate and the shareholder levels. (S. Rept. No. 1983, 85th Cong., 2d Sess. 87 (1958).)

Because of the passthrough of income and loss to the shareholders of a subchapter S corporation, subchapter S is often described as a method of taxing corporations as if they were partnerships. In fact, there are a number of significant differences in tax treatment under the partnership (subchapter K) and subchapter S provisions. For example, the partnership provisions provide a complete passthrough of the tax characteristics of the items of income and deduction incurred by the partnership, while the subchapter S provisions do not provide such a passthrough (except for capital gains). Under the partnership provisions, a distribution that does not exceed a partner's basis in his partnership interest generally is treated as a nontaxable return of capital. In many instances, a similar distribution to a subchapter S shareholder is treated as a taxable distribution. Under the partnership provisions, a loss carryover is allowed to the extent that losses exceed a partner's basis in his partnership interest as of the close of the year; in the comparable subchapter S situation, no loss carryover is available.

The experience of taxpayers with subchapter S attests to many "traps" for those not knowledgeable about its technical provisions. These unintended adverse tax consequences most often involve (1) unintentional violation of the continuing eligibility rules, resulting in retroactive terminations of elections; (2) the making of taxable distributions which were intended to be tax-free distributions of previously taxed income; and (3) a shareholder's having an insufficient basis to absorb his or her share of the corporation's loss, resulting in the permanent disallowance of that part of the loss.

The history of subchapter S also indicates that knowledgeable taxpayers may have derived some unintended benefits from the subchapter S provisions. Examples of such benefits include the deferral of income resulting from the selection of a taxable year for the corporation which is different from that of the majority of its shareholders, and the use of the retroactive termination provisions of subchapter S to prevent the passthrough of a substantial amount of income to the shareholders.

H.R. 6055

Since the enactment of subchapter S in 1958, various studies undertaken by government and professional groups have recommended revisions of subchapter S to simplify and modify its operation. A study by the staff of the Joint Committee on Taxation to simplify subchapter S was published on April 30, 1980. H.R. 6055 (and an identical bill, S. 2350 (introduced by Senators Dole and Long)) are based largely on the recommendations of that study. In addition, comments have been received from the Treasury, the staffs of the tax-writing committees, the tax section of the American Bar Association, the Federal tax division of the American Institute of Certified Public Accountants, and other professional groups and individuals. These comments have been taken into account in developing the introduced bills.

II. SUMMARY

In general, H.R. 6055 (the Subchapter S Revision Act of 1982) is intended to simplify and modify the tax rules relating to eligibility for subchapter S status and the operation of subchapter S corporations. This would be accomplished by removing eligibility restrictions that appear unnecessary and by revising the rules relating to income, distributions, etc., that tend to create traps for the unwary. The principal changes that would be made by the bill are summarized below.

Eligibility

With respect to initial and continued eligibility of a corporation for subchapter S treatment, the following changes would be made:

(1) The number of permitted shareholders would be increased from 25 to 35;

(2) Differences in voting rights in common stock would not violate the one-class-of-stock requirement;

(3) The present law rule which automatically terminates a corporation's subchapter S election if more than 20 percent of a corporation's gross receipts for any taxable year is passive investment income would be eliminated for corporations which do not have accumulated earnings and profits at the close of the taxable year; and

(4) A person who becomes a shareholder of a subchapter S corporation after the initial election of subchapter S status would not have the power to terminate the election by affirmatively refusing to consent to the election. Accordingly, the new shareholder would be bound by the initial election until the election is revoked by stockholders holding a majority of the stock.

Elections, revocations and terminations

The bill would provide that an election made on on before the fifteenth day of the third month of the taxable year would be effective for the entire taxable year if all persons who held stock in the corporation during that year were individuals, estates, and qualified trusts, and if all persons who held stock in the corporation at any time during the year up to the time the election is made consent to the election. If these requirements are not met, or if the election is made later than the fifteenth day of the third month of the taxable year, it would not be effective until the subsequent taxable year.

An event occurring during the taxable year which causes a corporation to fail to meet the definition of an eligible corporation would terminate the election as of the day on which the event occurred (rather than as of the first day of the taxable year in which the event occurred, as under present law). To minimize the effect of inadvertent termination, the bill would provide that the Internal Revenue Service

may waive the terminating event so that the corporation may continue to be a subchapter S corporation notwithstanding that event.

The bill would provide that an election could be revoked by those shareholders holding a majority of the corporation's voting stock (as contrasted with the current rule, which requires all shareholders to consent to a revocation). The present law rule allowing a revocation filed during the first month of the taxable year to be effective for that entire taxable year would be modified so that such a retroactive revocation may be filed on or before the fifteenth day of the third month of the taxable year.

Passthrough of income, etc.

The bill would provide that the character of items of income, deduction, loss, and credits of the corporation would pass through to the shareholders in the same general manner as the character of such items of a partnership passes through to partners. Thus, for example, such items as tax-exempt interest, capital gains and losses, percentage depletion, the source or allocation of foreign income or loss, and foreign income taxes would pass through and retain their character in the hands of shareholders.

As is the case under present law with respect to losses, income would be passed through and allocated to shareholders on a per-share, per-day basis.

Selection of taxable year

Under the bill, rules generally similar to those applicable to partnerships would apply to the selection of a taxable year for a subchapter S corporation. The taxable year of a corporation which makes a new subchapter S election after the date of enactment of the bill would be required to be either the calendar year, or any other accounting period for which the corporation establishes a business purpose to the satisfaction of the Treasury Department. These rules also would apply to corporations currently operating under subchapter S. However, a corporation with a subchapter S election in effect on December 31, 1982, could continue its current taxable year so long as 50 percent or more of the outstanding stock in the corporation on that date continue to be owned by the same shareholder. For purposes of this transitional rule, transfers of stock through inheritance would not be considered changes in ownership.

Carryforward of loss

Under the bill, a subchapter S shareholder would be entitled to carry forward a loss to the extent that the amount of the loss passed through for the year exceeds the aggregate amount of the bases in his subchapter S stock and loans to the corporation. The loss carried forward could be deducted only by that shareholder if and when the basis in his or her stock of, or loans to, the corporation is restored.

Distributions

The rules relating to distributions from subchapter S corporations would be extensively revised.

Under the new rules, a corporation would not have earnings and profits attributable to any taxable year beginning after the date of

enactment if a subchapter S election is in effect for that year. For corporations with no earnings and profits, the amount of the distribution (generally cash plus the fair market value of property) would be tax-free and would reduce the shareholder's basis in his or her stock. To the extent that the amount of the distribution exceeded the amount of the basis in the stock, capital gains would result.

For corporations with accumulated earnings and profits, the distribution would be treated as a distribution by a corporation without earnings and profits to the extent of the shareholder's portion of the undistributed amount of subchapter S gross income less deductible expenses (an "accumulated adjustment account"). Any amount in excess of the accumulated adjustment account would be treated under the usual corporate rules, first as a distribution out of accumulated earnings and profits to the extent thereof.

Under the bill, both taxable and nontaxable income and deductible and nondeductible expenses, respectively, would serve to increase and decrease the subchapter S shareholder's basis in his or her stock, of and loans to, the corporation. These rules are generally analogous to those provided for partnerships. Also, unlike present law, basis would be restored to debt obligations as well as stock. Restoration of basis would be made first to debt (to the extent of prior reductions) and then to stock. Under the bill, gain would be recognized by a subchapter S corporation upon nonliquidating distributions of appreciated property.

Qualified plans and fringe benefits

Under the bill, rules similar to the partnership tax rules would apply to pension and profit-sharing plans of a subchapter S corporation and to employee fringe benefits. For this purpose, persons owning two percent or more of the corporate stock would be treated as partners and a 10-percent owner would be treated as an owner-employee.

Treatment of transactions between corporation and related parties

Under the bill, amounts accruing to any cash-basis shareholder owning two percent or more of the corporation's stock would be deductible only when paid.

Administration

The bill would provide that the items of subchapter S income, deductions, and credits would be determined in audit and judicial proceedings at the corporate level rather than separately with each shareholder. Shareholders would be given notice of, and the opportunity to participate in, Internal Revenue Service proceedings with the corporation. (A similar provision is contained in H.R. 6300, "The Tax Compliance Act of 1982.")

Effective date

The bill would be effective for taxable years beginning after December 31, 1982, except that existing subchapter S pension and profit-sharing plans would not need to conform to the new rules before 1985.

III. PRESENT LAW AND DESCRIPTION OF BILL

A. Eligibility for Subchapter S Treatment

Present Law

Under present law, a corporation is eligible to elect and continue subchapter S status only if it (i) has no more than 25 shareholders,[1] (ii) has no shareholder other than an individual who is a citizen or resident of the United States, an estate, or certain types of trusts[2] (grantor trusts, voting trusts, testamentary trusts for a 60-day period, and certain "qualified subchapter S trusts"), (iii) is not a member of an "affiliated group" of corporations, and (iv) has only one class of stock.

A valid subchapter S election will be terminated if a new shareholder affirmatively refuses to consent to the election, if the election is revoked by all the shareholders, if more than 80 percent of the corporation's gross receipts for any taxable year are derived from sources outside the United States, or if more than 20 percent of the gross receipts for any taxable year consist of royalties, rents, interests, dividends, annuities, or gain on the sale or exchange of stock or securities.

Explanation of Provisions

1. Permitted number of shareholders (sec. 1361(b)(1)(A)) [3]

The number of permitted shareholders would be increased from 25 to 35. This number would correspond to the private placement exemption under Federal securities law.[4]

2. One class of stock requirement (secs. 1361 (b)(1)(D) and (c)(4))

The outstanding shares of the corporation must continue to be identical as to the rights of the holders in the profits and in the assets

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[1] The maximum number was set at 10 when subchapter S was enacted and was increased to 15 for certain corporations by the Tax Reform Act of 1976. The Revenue Act of 1978 set the limit at 15 for all corporations. The Economic Recovery Tax Act of 1981 increased the limit to 25.

For purposes of determining the number of shareholders, a husband and wife are treated as one shareholder.

[2] Trusts were not eligible to be shareholders under subchapter S, as enacted. Voting trusts, grantor trusts, and testamentary trusts became eligible shareholders under the Tax Reform Act of 1976. The Economic Recovery Tax Act of 1981 permitted as shareholders, trusts to which sec. 678 applies (under which a person other than the grantor is treated as the owner), and "qualified subchapter S trusts" (i.e., certain trusts in which the income beneficiary elects to be taxed, as the owner).

[3] References are to sections of the Internal Revenue Code of 1954 as proposed to be amended by the bill.

[4] Rule 506 (which will replace rule 146, effective July 1, 1982) of Regulation D issued pursuant to sec. 4(2) of the Securities Act of 1933.

of the corporation. However, unlike present law, differences in voting rights among shares of common stock would be permitted by the bill.[5]

3. Affiliated group (secs. 1361(b)(2)(A) and (c)(5))

The bill would retain the rule that a member of an affiliated group of corporations is not eligible for subchapter S status; that is, an electing corporation cannot own 80 percent or more of the stock of another corporation unless the other corporation has not begun business and has no taxable income. The bill would provide that this rule also applies to the holding of any subsidiary, whether or not the corporation would be eligible to file a consolidated return with its subsidiary.

4. Eligible shareholders (secs. 1361(b)(1)(B), (c)(2), (c)(3), and (d))

Present law would be retained. Only individuals (other than nonresident aliens), estates, and certain trusts would be eligible to hold stock in the corporation. Foreign trusts, like foreign corporations and nonresident aliens, would not be eligible shareholders.

5. Source of income (secs. 1361(b)(2) and 1362(d)(3) and (4))

The provision of present law that a subchapter S corporation may not derive more than 80 percent of its gross receipts from sources outside the United States would be retained.

The bill would generally repeal the requirement that a subchapter S corporation may not have more than 20 percent of its gross income in the form of passive investment income. However, that rule would continue to apply to those corporations which have, at the close of the taxable year, accumulated earnings and profits from years prior to electing the new subchapter S provisions.

In addition, a financial institution which is allowed a deduction for bad debts under section 585 or 593, or an insurance company subject to tax under the special insurance company rules of the Code, could not elect subchapter S.[6] These corporations are entitled to certain deductions not generally allowed to individuals. Many of these corporations are not eligible for subchapter S treatment under present law because of the passive income rules.

Possession corporations, DISC's, and former DISC's would continue to be ineligible to elect subchapter S.[7]

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[5] H.R. 6055 would not amend the present law rules determining whether a purported debt instrument constitutes a second class of stock. The courts have ruled certain instruments are permissible under present law where their existence offered no tax avoidance possibilities, notwithstanding that under traditional tax concepts these instruments would have normally been considered stock for tax purposes. (see e.g., *Portage Plastics Co.* v. *United States*, 486 F. 2d 632 (7th Cir. 1973), and the cases cited therein). The Internal Revenue Service has announced that it will not litigate cases factually similar to the facts in those cases. (TIR–1248 (July 27, 1973)).

In addition, under present law, a subchapter S corporation may have outstanding options and warrants to acquire stock, or debentures that are convertible into stock (Rev. Rul. 67–269, 1967–2 C.B. 298).

[6] The Internal Revenue Service has ruled that life insurance companies may not qualify as subchapter S corporations under present law (Rev. Rul. 74–344, 1974–2 C.B. 273). The Service has also ruled that stock casualty insurance companies taxable under sec. 831(a) may elect subchapter S treatment (Rev. Rul. 74–437, 1974–2 C.B. 274).

[7] Regulated investment companies and real estate investment trusts would continue to be ineligible because of the numerical shareholder limitations.

B. Election, Revocation, and Termination

Present Law

Under present law, an election to be taxed as a subchapter S corporation may be made for any taxamle year at any time during the preceding taxable year or at any time during the first 75 days of the taxable year.[8] An election continues in effect for subsequent taxable years until it is terminated.

In order for an election to be effective, each shareholder on the day the election is made must consent to the election. If a subchapter S election is terminated, a new election cannot be made by the corporation (or its successor) for any year prior to its fifth taxable year beginning after the taxable year during which the termination is effective, unless the Internal Revenue Service consents to an earlier election.

Under present law, the termination of an election is generally retroactive to the first day of the taxable year in which the terminating event occurred. A termination automatically occurs if the corporation fails to meet any of the eligibility requirements for subchapter S treatment. An election also terminates if all the shareholders of the corporation consent to a revocation. A revocation generally is effective for the following taxable year. Finally, an election can be terminated if a new shareholder affirmatively refuses to consent to the election on or before the 60th day after he or she acquired the stock.

Explanation of Provisions

1. Making an election (sec. 1362 (a) and (b))

An election made on or before the fifteenth day of the third month of a corporation's taxable year would be effective for the entire taxable year if the corporation meets all the eligibility requirements (including shareholder eligibility requirements) for that entire taxable year, and if all persons who held stock in the corporation at any time during the portion of the year before the election was made, consented to the election.

If the eligibility requirements are not met for the entire year in which the election is made, if consents of all shareholders who had disposed of their stock prior to the making of the election are not obtained, or if the election is made after the fifteenth day of the third month of the year, the election would not become effective until the next taxable year. This rule would eliminate any problem of allocation of income and loss with respect to pre-election stockholders who either were ineligible to hold subchapter S corporation stock or did not consent to the election.

[8] Prior to an amendment made by the Revenue Act of 1978, the election was required to be made during the two-month period beginning one month before the start of the taxable year.

2. Termination of election (secs. 1362 (d), (e), and (g))

Generally, specific events during the taxable year which cause a corporation to fail to meet the definition of a small business corporation would result in a termination of the election as of the date on which the event occurred (rather than as of the first day of the taxable year, as under present law). The events causing disqualification would be: (1) exceeding the maximum allowable number of shareholders; (2) transfer of stock to a corporation, partnership, ineligible trust, or nonresident alien; (3) the creation of a class of stock other than the voting and nonvoting common stock allowed; and (4) the acquisition of a subsidiary (other than certain nonoperating subsidiaries).

The day before the day on which the terminating event occurs would be treated as the last day of a short subchapter S taxable year, and the day on which the terminating event occurs would be treated as the first day of a short regular (i.e. subchapter S) taxable year. There would be no requirement that the books of a corporation be closed as of the termination date. Instead the corporation would be required to allocate the income or loss for the entire year (i.e., both short years) on a daily proration basis.

However, the corporation could elect, with the consent of all persons who were shareholders during the short subchapter S year, to report the taxable income or loss on each return (subchapter S and subchapter C) on the basis of income or loss shown on the corporation's permanent records (including work papers). Under this method, items would be attributed to the short subchapter S and subchapter C years according to the time they were incurred or realized, as reflected in such records.

The short subchapter S and subchapter C taxable years would be treated as one year for purposes of carrying over previous subchapter C losses. The income allocated to the subchapter C taxable year would be subject to annualization for purposes of applying the corporate rate brackets. The return for the short subchapter S year would be due on the same date as the return for the short subchapter C year is due.

As under present law, if a corporation's election terminates because the foreign income limitation or the passive income limitation (to the extent still applicable) is violated for any taxable year, the election is terminated for that entire taxable year.

If an election is terminated, a new election cannot be made, without the consent of the Internal Revenue Service, for 5 taxable years, as under present law.

3. Revocation of election (sec. 1362(d)(1))

An election could be revoked only by action of shareholders holding more than one-half of the corporation's voting stock.

The present law rule allowing a revocation filed during the first month of the taxable year to be effective for that entire taxable year would be modified. Under the bill, a revocation filed up to and including the fifteenth day of the third month of the taxable year would be effective for the entire taxable year, unless a prospective effective date was specified. The period during which a retroactive revocation could be filed thus would correspond to the time period in which a retroactive election may be made. Revocations made after the fifteenth day of the third month of the taxable year would be effective on the first day of the following taxable year unless the revocation stated some other

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prospective date, in which case it would be effective as of the specified date.

Revocations which designate a prospective effective date would result in the splitting of the year into short subchapter S and subchapter C taxable years with the tax consequences as discussed above in connection with terminations.

A person becoming a shareholder of a subchapter S corporation after the initial election would not have the power to terminate the election by affirmatively refusing to consent to the election. He or she would be bound by the initial election.

4. Inadvertent terminations (sec. 1362(f))

If the Internal Revenue Service determines that a corporation's subchapter S election was inadvertently terminated, the Service could waive the effect of the terminating event for any period if the corporation timely corrects the event and if the corporation and the shareholders agree to be treated as if the election had been in effect for such period.

C. Treatment of Income, Deductions, and Credits

Present Law

Under present law, a subchapter S corporation is not subject to the corporate income tax. An exception to this rule is the imposition of a capital gains tax on certain subchapter S corporations, in order to discourage the making of a "one-shot" subchapter S election.

Instead, the undistributed taxable income of the corporation is includible in gross income of the shareholders owning stock on the last day of the corporation's taxable year. Similar rules pass through the credits of the corporation to its shareholders. Any net operating loss of the corporation is passed through to the shareholders, based on each shareholder's pro rata share of ownership in the corporation during the taxable year. Specific items (such as charitable contributions), other than the long-term capital gain portion of income, do not pass through.

Income may be reallocated by the Internal Revenue Service among shareholders who are family members as necessary to reflect the value of services rendered.

A shareholder may deduct a loss only to the extent of the shareholder's adjusted basis in the stock of the corporation plus the shareholder's adjusted basis of any indebtedness of the corporation to the shareholder. Losses in excess of this limitation may not be carried over.

A shareholder's basis in the stock of the corporation is increased by the amount of undistributed taxable income taken into account, and decreased by the shareholder's share of the net operating loss passed through. Losses reduce basis in any indebtedness after the stock basis has been reduced to zero.

Explanation of Provisions

1. Treatment of corporations (secs. 1363(a), 1371(d), and 1374)

As under present law, a subchapter S corporation would not be subject to the corporate income tax, except for the present tax on capital gains. This tax, which is imposed to limit use of subchapter S on a temporary basis in order to pass capital gains through to shareholders, would continue.

Under the bill, the tax imposed under section 47 in the case of an early disposition of property on which an investment credit was claimed would be imposed on the corporation with respect to property purchased by the corporation prior to the effective date of the subchapter S election. The election would not be treated as a disposition of the property by the corporation.

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2. *Treatment of shareholders (secs. 1363 (b) and (c), 1366, 1367, 1371(b) and 1373)*

In general

The bill would set forth new rules for the taxation of income earned by, and the allowance of losses incurred by, subchapter S corporations. These rules generally follow the present law rules governing the taxation of partners with respect to items of partnership income and loss.

Computation of corporate items

A subchapter S corporation's taxable income would be computed under the same rules presently applicable to partnerships under section 703, except that the amortization of organization expenditures under section 248 would be an allowable deduction. As in the case of partnerships, deductions generally allowable to individuals would be allowed to subchapter S corporations, but provisions of the Code governing the computation of taxable income which are applicable only to corporations, such as the dividends received deduction, would not apply. Items, the separate treatment which could affect the liability of any shareholder would be treated separately. Elections would generally be made at the corporate level, except for those elections which the partners of a partnership may make separately (such as the election to claim the foreign tax credit).

Passthrough of items

The following examples illustrate the operation of the bill's passthrough rules:

a. *Capital gains and losses.*—Gains or losses from sales or exchanges of capital assets would pass through to the shareholders as capital gains or losses. Net capital gains would no longer be offset by ordinary losses at the corporate level.

b. *Section 1231 gains and losses.*—The gains and losses on certain property used in a trade or business would be passed through separately and would be aggregated with the shareholder's other section 1231 gains and losses. Thus, section 1231 gains would no longer be aggregated with capital gains at the corporate level and passed through as capital gains.

c. *Charitable deductions.*—The corporate 10-percent limitation would no longer apply to contributions by the corporation. As in the case of partnerships, these deductions would retain their character as charitable contributions when passed through to the shareholders, at which level they would be subject to the individual limitations on deductibility.

d. *Tax-exempt interest.*—Tax-exempt interest would pass through to the shareholders as such and would increase the shareholders' basis in their subchapter S stock. Because of the limitation of the earnings and profits account (discussed in III–D, below), subsequent distributions by the corporation would not result in taxation of the tax-exempt income.

e. *Foreign taxes.*—Foreign taxes paid by the corporation would pass through as such to the shareholders, who would claim such taxes either as deductions or credits (subject to the applicable limitations). However, a subchapter S corporation would not be

eligible for the foreign tax credit with respect to taxes paid by a foreign corporation in which the subchapter S corporation is a shareholder; therefore, these taxes would not pass through to its shareholders. Special foreign loss recapture provisions similar to those of section 904(f) would apply to a corporation electing out of subchapter S which had previously passed foreign losses through to its shareholders. Rules concerning the source of income, including the capital gains source rule of section 904(b), and the amount of creditable taxes, such as the rules of section 907(a), would apply at the shareholder level.

f. *Credits.*—As with partnerships, items involved in the determination of credits, such as the basis of section 38 property for purposes of computing amount of qualified investment eligible for the investment tax credit, would pass through to the subchapter S corporation's shareholders.

g. *Depletion.*—The present rules governing depletion with regard to partnership interests in minerals would apply to depletion of properties of a subchapter S corporation (see discussion in section III–F, below, for special rules in the case of oil and gas properties).

h. *Foreign income and loss.*—Domestic losses and foreign losses would pass through separately. If a corporation had foreign losses and domestic income, or vice versa, each would pass through separately to shareholders without aggregation at the corporate level.

i. *Other items.*—Limitations on the used property investment tax credit (sec. 48(c)), the expensing of certain depreciable business assets (sec. 179), and the amortization of reforestation expenditures (sec. 194) would apply at both the corporate level and shareholder level, as in the case of partnerships.

Carryovers from years in which the corporation was not a subchapter S corporation would not be allowed to the corporation while in subchapter S status.

Shareholders treatment of items

As with the partners of a partnership, each shareholder of a subchapter S corporation would take into account separately his or her pro rata share of items of income, deduction, credit, etc. of the corporation. These rules would parallel the partnership rules under section 702. Each shareholder's share of the items would be taken into account in the shareholder's taxable year in which the corporation's year ends.

For these purposes, a shareholder's pro rata share generally would be determined in the same manner as the present law rule for passing through net operating losses. In cases of transfers of subchapter S stock during the taxable year, income, losses, and credits would be allocated in essentially the same manner as when the election terminates during the year. Thus, the allocation would be made on a per-share, per-day basis unless the corporation, with the consent of its shareholders, elected to allocate according to its permament records (including work papers).

A "conduit" rule for determining the character of items realized by the corporation and included in the shareholder's pro rata share would

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be the same as the partnership rule. Also, the "gross income" determinations made by a shareholder would parallel the partnership rule.

Under the bill, items taken into account by members of the family of a shareholder could be adjusted by the Internal Revenue Service wherever it is necessary to reflect reasonable compensation to the shareholder for services rendered or capital furnished to the corporation. Both the amount of compensation and the timing of the compensation could be so adjusted.

As under present law, a shareholder's allowable pro rata share of the corporation's loss would be limited to the sum of the shareholder's adjusted basis in the stock of the corporation plus the shareholder's adjusted basis of any indebtedness of the corporation to the shareholder. However, unlike present law, disallowed losses could be carried forward or allowed in any subsequent year in which the shareholder has adequate basis in such stock or debt.

Subsequent to a termination of a subchapter S election, these disallowed losses would be allowed if the shareholder's basis in his stock in the corporation is restored by the later of the following dates:

(1) One year after the effective date of the termination or the due date for the last subchapter S return, whichever is later; or

(2) 120 days after a determination that the corporation's subchapter S election had terminated for a previous year. (A determination would be defined as a court decision which becomes final, a closing agreement, or an agreement between the corporation and the Internal Revenue Service that the corporation failed to qualify.)

3. Basis adjustment (sec. 1367)

Under the bill, both taxable and nontaxable income and deductible and nondeductible expenses would serve, respectively, to increase and decrease a subchapter S shareholder's basis in the stock of the corporation. These rules would be analogous to those provided for partnerships under section 705. Unlike the partnership rules, however, to the extent property distributions are treated as a return of basis, basis would be reduced by the fair market value of these properties (see section III–D, below). Any passthrough of income for a particular year (allocated according to the proportion of stock held in the corporation) would first increase the shareholder's basis in loans to the corporation to the extent the basis was previously reduced by the passthrough of losses.

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D. Treatment of Corporate Distributions

Present Law

Under present law, the general rules applicable to distributions to shareholders by regular corporations apply to such distributions by subchapter S corporations. Under the normal corporate rules, distributions of money or other property are treated as taxable dividends, at fair market value, to the extent the corporation has either current or accumulated earnings and profits. Distributions in excess of earnings and profits are tax-free up to the shareholder's basis in the stock, and any excess is then treated as gain from the sale of the stock.

In addition to the regular rules, special rules also apply to distributions by subchapter S corporations. These rules allow a corporation to make tax-free cash distributions within 2½ months after the close of the taxable year out of the prior year's undistributed taxable income to the extent of the shareholder's portion of that income (sec. 1375(f)). Also, cash distributions which are not distributions of the prior year's undistributed taxable income and which are in excess of current earnings and profits qualify as tax-free distributions of a shareholder's previously taxed income to the extent of that income (sec. 1375(d)). The right to receive previously taxed income is not transferable and terminates when the corporation's subchapter S election terminates.

Property distributions by subchapter S corporations are treated differently from cash distributions in that they do not reduce the amount of the current year's undistributed taxable income taxed to the shareholder and do not qualify as distributions of either undistributed taxable income or of previously taxed income. Also, property distributions reduce earnings and profits by an amount equal to the adjusted basis of the property distributed.

In summary, distributions of money have the following tax consequences in the following order: (1) a tax-free distribution of undistributed taxable income to the extent thereof, if made within 2½ months after the end of the corporation's taxable year; (2) a dividend to the extent of current earnings and profits; (3) a tax-free distribution to the extent of previously taxed income (a special rule reverses the order of items (2) and (3) in the case of certain accelerated depreciation); (4) a dividend to the extent of accumulated earnings and profits (the shareholder may elect to reverse the order of items (3) and (4)); (5) reduction in the shareholder's basis in the stock of the corporation; and (6) a taxable disposition of the stock.

Property distributions have the following tax consequences under present law: (1) A dividend distribution to the extent of either current or accumulated earnings and profits; (2) reduction in the shareholder's basis in the stock of the corporation; and (3) a taxable disposition of the stock.

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Generally, distributions have no tax effect on the distributing corporation, except for distributions of LIFO inventory where the "LIFO reserve" is recaptured, or distributions of property where the liability exceeds basis, which results in gain to the extent of the excess (sec. 311(a), (b), and (c)).

Explanation of Provisions

1. Taxation of shareholders (secs. 1368 and 1371(c))

Under the bill, the amount of any distribution to a shareholder would equal the amount of cash distributed plus the fair market value of any property distributed, as under present law.

The amount of a distribution by a corporation without accumulated earnings and profits would be tax-free to the extent of the shareholder's basis in the stock. The distribution would be applied to reduce the shareholder's basis in his stock. To the extent the amount of the distribution exceeds basis, capital gains would result.

All post-1982 earnings of a subchapter S corporation would not be considered earnings and profits for this purpose. Thus, under the bill, a corporation would not have earnings and profits attributable to any taxable year beginning after 1982 if a subchater S election was in effect for that year. However, a corporation could have earnings and profits attributable to (1) taxable years for which an election was not in effect, (2) taxable years beginning prior to 1983 for which an election was in effect, and (3) a corporate acquisition which results in a carryover of earnings and profits under section 381.

A distribution by a subchapter S corporation with accumulated earnings and profits would be treated as if made by a subchapter S corporation with no earnings and profits up to the amount in the corporation's accumulated adjustment account (i.e., gross income less deductible expenses, not previously distributed). Any excess would then be treated as a dividend up to the amount of accumulated earnings and profits; any residual amount would then be applied against the shareholder's remaining basis in his stock; and, finally, any remainder of the distribution would be treated as capital gain.

Thus, under the bill, shareholders of subchapter S corporations with accumulated earnings and profits generally would be assured of tax-free treatment with respect to distributions, regardless of when made, to the extent of the corporation's accumulated adjustment account.

The rules described above would apply to the transferee of stock in a subchapter S corporation regardless of the manner in which the transferee acquired the stock.

2. Taxation of corporations (sec. 1363(d))

Gain would be recognized by a subchapter S corporation on any distribution of appreciated property, other than distributions in complete liquidation of the corporation. This rule results from the combination of the elimination of earnings and profits for subchapter S years and the retention of the fair market value distribution rule. Without this rule, assets could be distributed tax-free (except for recapture in certain instances) and subsequently sold without income recognition to the selling shareholder because of the stepped-up fair market value basis.

E. Taxable Year of Corporation

Present Law

Under present law, shareholders of a subchapter S corporation take into account undistributed taxable income and net operating losses for their taxable years in which the subchapter S taxable year ends. No special rules limit the taxable year which the corporation may select. As a result, a deferral of tax can result if a taxable year ending shortly after the end of the shareholder's taxable year is selected.

Explanation of Provision (sec. 1378)

Under the bill, the taxable year of a subchapter S corporation would be required to be either a year ending December 31, or any other taxable year for which it establishes a business purpose to the satisfaction of the Internal Revenue Service.

A corporation which is a subchapter S corporation during the taxable year which includes December 31, 1982, would be permitted to retain its existing taxable year so long as at least 50 percent of the stock in the corporation is owned by the same persons who owned such stock on December 31, 1982. However, to retain subchapter S status for taxable years beginning after the day on which more than 50 percent of its stock have changed ownership subsequent to December 31, 1982, the corporation would have to conform to the general taxable year rule and either use the calendar year or establish a business purpose for a different year. For these purposes, transfers of shares through inheritance would not be considered changes in ownership.

F. Other Rules

1. Treatment of pension and profit-sharing plans

Present Law

Under present law, a pension or profit-sharing plan of a subchapter S corporation is subject to special rules which are in addition to the tax-qualification requirements applicable to plans of other corporations. Under these special rules, annual employer contributions to a profit-sharing plan which can be excluded from the gross income of a shareholder-employee (an employee owning more than five percent of the corporation's stock) are limited to the lesser of $15,000 or 15 percent of compensation paid to the shareholder-employee (sec. 1379(b)). A corresponding limit applies to benefits which can be provided to a shareholder-employee under a defined benefit pension plan (sec. 401(j)). These limits are generally lower than the overall limits on contributions and benefits which apply with respect to all employees under qualified plans (sec. 415). In addition, the special qualification rules for a subchapter S plan limit to $200,000 the amount of compensation paid to a plan participant which can be taken into account under the plan (sec. 401(a)(17)) and generally preclude benefits forfeited by a separating employee from inuring to the benefit of a shareholder-employee under the plan (sec. 1379(a)). Also, a plan of a subchapter S corporation is not permitted to make loans to a shareholder-employee (sec. 4975(d)).

The special qualification rules for a subchapter S corporate plan are the same as (or equivalent to) some of the special qualification rules that apply to a plan benefiting a self-employed individual (a sole proprietor or a partner), commonly referred to as an "H.R. 10" plan or "Keogh" plan. However, if an H.R. 10 plan benefits an owner-employee (a sole proprietor or a partner whose partnership interest exceeds 10 percent), the H.R. 10 plan is required to meet additional special standards. These special standards

(1) require that the plan benefit all employees who have completed at least three years of service with the employer (except that an owner-employee must consent to be covered by the plan);

(2) require that an employee's rights to plan benefits are nonforfeitable at the time the contributions are made (i.e., the plan must provide full and immediate vesting);

(3) preclude a defined benefit pension plan from reducing pension benefits on account of social security benefits payable to the employee, and limit the extent to which contributions for an employee under a defined contribution plan (e.g., a profit-sharing plan) can be reduced on account of the social security tax imposed on the employer with respect to the employee's wages;

(4) require that the trustee of a trust forming a part of the plan be a bank or other qualifying financial institution;

(5) limit (or in some cases preclude) voluntary nondeductible contributions to the plan by an owner-employee;

(6) generally prohibit the payment of benefits to an owner-employee before the owner-employee attains age 59½; and

(7) require that benefits payable with respect to a deceased owner-employee generally be paid to the employee's beneficiary within five years after the employee's death.

In addition, under the income tax rules, if an owner-employee receives a distribution from an H.R. 10 plan before attaining age 59½ or becoming disabled, the amount of the distribution includible in gross income is subject to an additional 10 percent penalty tax, and generally no contributions may be made to an H.R. 10 plan on his or her behalf for the five taxable years following the taxable year of the distribution. Also, if a self-employed individual (whether or not an owner-employee) participating in an H.R. 10 plan borrows from the plan or uses an interest in the plan as security for a loan, the transaction is treated as a plan distribution and the usual tax rules for distributions apply. In addition, the rules of all H.R. 10 plans require that the payment of plan benefits to an owner-employee begin no later than the taxable year in which the owner-employee attains age 70½.

Explanation of Provision (sec. 1372(a))

A pension or profit-sharing plan of a subchapter S corporation generally would be treated as an H.R. 10 plan under the tax qualification requirements of the Code and also for purposes of the other tax rules relating to qualified plans. Under the bill, any employee owning more than two percent of the corporation's stock would be treated as a self-employed individual (*i.e.*, as a partner). Any employee owning more than 10 percent of the corporation's stock would be treated as an owner-employee (*i.e.*, as a sole proprietor or a partner whose partnership interest exceeds 10 percent).

2. Treatment of fringe benefits

Present Law

Under present law, the statutory exemptions for fringe benefits applicable to shareholder-employees of regular corporations also apply in the case of subchapter S corporations. The benefits include the following:

(1) the $5,000 death benefit exclusion (sec. 101(b));

(2) the exclusion from income of amounts paid for an accident and health plan (secs. 105 (b), (c), and (d));

(3) the exclusion from income of amounts paid by an employer to an accident and health plan (sec. 106);

(4) the exclusion of the cost of up to $50,000 of group-term life insurance on an employee's life (sec. 79); and

(5) the exclusion from income of meals or lodging furnished for the convenience of the employer (sec. 119).

Explanation of Provision (sec. 1372(c))

Under the bill, the treatment of fringe benefits of any person owning more than two percent of the stock of the corporation would be treated in the same manner as a partner in a partnership. Thus, for example, amounts paid for the medical care of a shareholder-employee would be deductible by that individual only to the extent personal medical expenses would be allowed as an itemized deduction under section 213.

3. Treatment of oil and gas production

Present Law

Under present law, the allowance for depletion, including depletion with respect to oil and gas wells, for a subchapter S corporation, is computed by the corporation and taken into account in determining the taxable income of the subchapter S corporation. The depletion deductions taken into account in determining earnings and profits of a subchapter S corporation are computed based on cost depletion. Thus, when a subchapter S corporation claims percentage depletion, it may generate current earnings and profits in excess of taxable income, and amounts distributed in excess of taxable income may be taxed as a dividend to the shareholders.

The right to claim percentage depletion with respect to oil and gas wells is limited under present law to certain independent producers and royalty owners. To prevent a proliferation of interests eligible for percentage depletion, present law provides anti-transfer rules which limit the ability of transferees to claim percentage depletion on production attributable to an interest in proven oil or gas properties transferred after 1974. Generally, a transfer from an individual to a subchapter S corporation will result in the loss of percentage depletion unless the special rules provided in section 613A(c)(10) are satisfied. In essence, these rules require that the corporation's stock be issued solely in exchange for oil and gas properties and that there be an allocation of the barrel-per-day limitation on percentage depletion between the corporation and the individuals contributing the property. Similarly, the transfer of an oil and gas property from the subchapter S corporation to one or more of the shareholders would result in the loss of percentage depletion for production from the transferred property. However, the subchapter S election by a regular corporation is not treated as a transfer (Rev. Rul. 80–43, 1980–1 C.B. 133).

Under present law, the windfall profit tax is imposed upon the producer of domestic crude oil. In the case of a subchapter S corporation, the producer of crude oil is the corporation and not the individual shareholders. The transfer of property from or to a corporation would be a transfer resulting in the loss of lower rates on production by independent producers, unless one of the specified exceptions to the anti-transfer rules applied.

Explanation of Provision (sec. 3 (a) and (b) of the bill)

Under the bill, the allowance for depletion in the case of oil and gas properties held by a subchapter S corporation would be computed in a manner similar to that used in the computation of deple-

tion in the case of partnerships. Specifically, the percentage or cost depletion allowance would be available directly to the shareholders of the subchapter S corporation and would be computed separately by each individual shareholder. Each shareholder would be treated as having produced his pro rata share of the production of the subchapter S corporation and each shareholder would be allocated his respective share of the adjusted basis of the subchapter S corporation in each oil or gas property held by the corporation.

For purposes of applying the anti-transfer rules in the percentage depletion provisions, the subchapter S corporation would be treated as a partnership and the shareholders would be treated as partners. Similarly, an election by a regular corporation to become a subchapter S corporation would be treated as a transfer of all the property of the corporation effective on the day on which the election takes effect. Finally, for purposes of the anti-transfer rules, the termination of a subchapter S election and the reversion to regular status would be treated as a transfer by the shareholders of all the assets of the subchapter S corporation to the regular corporation.

For purposes of the windfall profit tax, a subchapter S corporation would be treated as a partnership. Specifically, any subchapter S corporation which would otherwise be treated as a producer of crude oil would not be so treated; instead, all the crude oil produced by that corporation would be allocated among the shareholders in proportion to each shareholder's pro rata share of the income of the corporation. Each shareholder entitled to an allocation of crude oil would be treated as the producer of that crude oil for purposes of the windfall profit tax. Thus, for purposes of the independent producer lower rates (including the anti-transfer rules), the subchapter S corporation would be treated as a partnership and the shareholders of the subchapter S corporation would be treated as partners of the partnership.

4. Treatment of expenses owed to shareholders

Present Law

Under present law, a subchapter S corporation, in order to obtain a deduction for business expenses or interest payable to a cash-basis shareholder owning (after application of the constructive ownership rules of sec. 267(c)) more than 50 percent of the stock of the corporation, must actually pay such items not later than 2½ months after the close of its taxable year. If the shareholder owns 50 percent or less of the stock, a subchapter S corporation on the accrual method of accounting may accrue the deduction (to the extent otherwise allowable) notwithstanding that the shareholder does not include the amount in income until actually paid.

Explanation of Provision (sec. 3(g) of the bill)

The bill would place a subchapter S corporation on the cash method of accounting for purposes of deducting those expenses and interest owed to a cash-basis shareholder who owns at least two percent of the stock in the corporation. Thus, the timing of the corporation's deductions (which are taken into account on the shareholder's returns) and the shareholder's income would match. Also, no deductions would be lost if payment is made after the 2½-month period expires.

G. Tax Adminisration Provisions

Present Law

Under present law, a taxpayer's individual tax liability is determined in proceedings between the Internal Revenue Service and the individual whose tax liability is in dispute. Thus, any issues involving the income or deductions of a subchapter S corporation are determined separately in administrative or judicial proceedings involving the individual shareholder whose tax liability is affected. Statutes of limitations apply at the individual level, based on the returns filed by the individual. The filing by the corporation of its return does not affect the statute of limitations applicable to the shareholders.

Explanation of Provision (sec. 1375)

Under the bill, the tax treatment of items of subchapter S income, loss, deductions, and credits generally would be determined at the corporate level. Shareholders would be given notice of any administrative or judicial proceeding at which such items would be determined. Further, each shareholder would be given the opportunity to participate in these proceedings. Shareholders would be required to file returns consistent with the corporate return or notify the Internal Revenue Service of the inconsistency. (H.R. 6300, "The Tax Compliance Act of 1982," contains similar provisions.)

H. Effective Date and Transitional Rules (sec. 1379)

The bill would apply to taxable years beginning after December 31, 1982. Existing subchapter S corporations would be treated under the new rules for the first taxable year beginning after that date. Tax-free distributions of undistributed taxable income from the last pre-enactment year could be made. Also, previously taxed income could be distributed during the first post-enactment year and the 2½-month period after the close of that year. Carryforwards, such as capital loss carryforwards and charitable contribution carryovers from the corporation's last pre-enactment year shall be treated as sustained in the first post-enactment year.

In the case of any pension or profit-sharing plan in existence on the date of enactment, the present rules of section 1379 would continue to apply for years beginning before 1985.

IV. GENERAL CONSIDERATIONS

Background

Although present law provides an elective system (subchapter S) to tax earnings of certain corporations to the shareholders, this system has led to certain problems for taxpayers and for the government. Some of the present rules may create "traps" for persons not entirely familiar with the provisions, may create anomalous results in certain situations, and can be used to derive unintended or unwarranted tax benefits by knowledgeable taxpayers.

Certain issues relating to these basic problems that the Subcommittee may wish to consider are described in this section of the pamphlet.

Treatment generally

A fundamental difficulty with the present subchapter S rules results from the fact that the present law provisions are basically modifications of the tax rules normally applicable to regular corporations. Under those provisions, a tax is imposed on the corporation's taxable income, and then distributions of corporate earnings are taxed separately to the shareholders as dividends. The tax rules applicable to regular corporations often do not provide an appropriate model for a coherent set of rules for an entity which "passes through" its income to its owners.

In contrast to the modified corporate rules of subchapter S, the Code contains a wholly different set of provisions governing the taxation of partnerships, which, like the provisions of subchapter S, are intended to tax entity earnings directly to the owners of the entity. Unlike the subchapter S provisions, the partnership provisions are not modeled after provisions designed to impose a separate entity tax, but are self-contained provisions designed to determine taxable income, gains and losses, and special items reportable by the partners.

In large part, the difference between the present subchapter S provisions and the partnership provisions reflects the fact that the tax status of a subchapter S corporation may change. The same legal entity that previously was a regular corporation may elect subchapter S treatment and thereafter once again may become a regular corporation. As the same entity, under present law it may embody the same characteristics that it had while in regular corporation status. For example—the basis of its assets, potential "recapture" items, accounting methods and elections may remain unchanged. Earnings which accumulated in the corporation prior to a change to subchapter S status are preserved and when such earnings are distributed, the shareholders will be subject to a tax on the dividends.

The retention of the corporation's accumulated earnings and profits after a corporation changes to subchapter S status is important under present law because under the regular corporate tax rules, distribu-

tions of the earnings are taxed to the shareholders as dividends. Under the corporate tax rules, corporate earnings of a regular corporation are taxed to the corporation at rates generally lower than the individual income tax rates. A tax is then imposed on the shareholders when the earnings are either distributed as a dividend, or distributed to the shareholders in liquidation of the corporation. In the latter situation, the tax is at capital gains rates. Also, rules are presently prescribed to prevent the improper accumulation of corporate income in order to avoid income tax on the shareholders.

In the case of a corporation which liquidates and then continues to conduct business as a partnership, present law (sec. 331) generally imposes a capital gains tax on each shareholder in an amount by which the shareholder's share of the net value of assets exceeds the shareholder's basis in its stock. Generally, such net value reflects the sum of previously undistributed corporate earnings, unrealized corporate gain, and shareholder investment. Thus, the capital gain reported by the shareholders reflects both after-tax corporate earnings which had been retained and unrealized appreciation in corporate assets. Under present law, when a corporation liquidates, accelerated depreciation, investment credits and other recapture items are recaptured at the corporate level as if the property had been sold at fair market value. The basis of the assets distributed by the corporation then are adjusted to fair market value.

In addition, present law contains elective rules (sec. 333) which are used for the liquidation of corporations with relatively low accumulated earnings. Under these rules, each individual shareholder's gain, to the extent of his or her share of the corporation's earnings and profits, is treated as ordinary income, and any remaining gain is deferred until the stock is sold, except to the extent the shareholder receives money or certain stock and securities in the liquidation.

Present law does not impose similar tax consequences when a regular corporation elects subchapter S status, even though the corporation will then be taxed somewhat like a partnership.

If the Subcommittee adopts favorable partnership-like changes, such as those proposed by H.R. 6055, the Subcommittee may wish to consider developing rules to more closely parallel the tax treatment of a corporation converting itself to a partnership. Adoption of such similar rules could simplify the operation of the subchapter S rules since the appropriate rules for a pass-through entity could be adopted with less need to be concerned with coordinating subchapter S rules with the regular corporate system. Also, if the underlying theory of subchapter S is that the corporate entity should be disregarded for tax purposes and the earnings from the corporate assets should be taxed in a manner similar to that of ownership through a sole proprietorship or partnership, the analogy of a corporate liquidation may be considered appropriate.

Passthrough and distributions generally

Tax practitioners generally agree that taxation of corporate income to subchapter S shareholders under a system modeled after the partnership provisions is a more appropriate single level tax scheme than present subchapter S rules. Under the partnership model, the electing corporation's income or loss would first be passed through to the share-

holders, with distributions being generally a return of the shareholders' investment, including previously taxed earnings. H.R. 6055 follows this approach. However, unlike in the case of a partnership, this passthrough treatment for a subchapter S corporation must be coordinated with the need to provide appropriate treatment for earnings which have accumulated in the corporation prior to the adoption of subchapter S status, and which later may be distributed. H.R. 6055 seeks to do this by retaining present law rules for the shareholder treatment of distributions out of prior accumulated earnings.

If a partnership passthrough system is adopted for subchapter S corporations, the subcommittee may wish to consider the proper treatment of certain items such as depletion, foreign items, pension benefits, and other fringe benefits, which are presently treated differently under subchapter S than under the partnership provisions.

Also, a corporate passthrough system needs to protect the regulator corporate tax system by preventing undue advantages by reason of electing subchapter S and then returning too quickly to the regular system. For example, both present law and H.R. 6055 tax certain capital gains at the corporate level (present sec. 1378) in order to reduce the advantage of a "one-shot" election.

Distributions of appreciated property

Under the partnership rules, distributions of appreciated property (if made to all partners pro-rata) do not trigger gain to the partnership and are not taxed to the partners. The partners generally take a carryover basis in the assets and therefore defer the gain until they sell the property. Rules are provided to prevent certain items of ordinary income from being converted to capital gains in the hands of the partners. Complex rules are also provided to treat certain non-pro rata distributions as exchanges of assets among the partners. On the other hand, the corporate provisions (including present subchapter S) generally do not provide for recognition of corporate gain (other than recapture) on distributions of appreciated property, but do provide for dividend treatment to the shareholders.

H.R. 6055 retains dividend treatment for the distribution of pre-subchapter S accumulated earnings. A fair market value basis for assets included in income as dividends is therefore required. At the same time, in order to prevent a step-up of basis in the case of distributions which are tax-free out of subchapter S earnings, H.R. 6055 provides for the recognition of gain on assets distributed by a subchapter S corporation. Recognition of gain on the distribution of appreciated assets by a subchapter S corporation would not result in a separate corporate tax, as would be the case if gain were recognized by a regular corporation distributing assets. Rather, recognition of gain could affect the timing and character of the gain taken into account by the shareholders, since there will be less gain to recognize on a later sale of a shareholder's stock, by reason of the increase in the basis of the stock for gain reported on the distribution.

The proper treatment of distributions of appreciated property is a difficult problem to resolve in designing a subchapter S system because of the need, on the one hand, to protect the integrity of the regular corporate system (which presumably would require some sort of shareholder tax when prior earnings are distributed) and, on the

other hand, to provide a rational passthrough system, under which deferral of gain on certain assets until disposed of by the shareholders may be appropriate (at least where no conversion of ordinary income to capital gain may occur and where gain or loss may not be assigned among the shareholders by the use of non pro-rata distributions).

If the Subcommittee should decide to treat the subchapter S election by an existing regular corporation as a liquidation and reconstitution of the business as described above to eliminate prior earnings and profits, the subcommittee may wish to apply rules similar to the partnership rules to property distributions.

Passive income

Under present law, the subchapter S election will terminate if, for any taxable year, more than 20 percent of the corporation's gross receipts consist of investment income. The introduced bill would continue this rule for corporations with earnings and profits accumulated from tax years prior to subchapter S status.

This passive income limitation was originally adopted in order to make subchapter S treatment available only to the conduct of active trades or businesses, and not to merely holding companies. The rule has prevented certain businesses, such as lending institutions and certain rental real estate operations, from electing subchapter S status and has presented definitional problems in determining whether certain other businesses qualify. The rule also prevents the incorporation of property, such as land used for rental purposes, where the sole purpose of the incorporation is not tax related (for example, to reduce probate costs in the case of the death of the owner) and no tax advantages are sought.

Some have raised the concern that the complete repeal of the passive income limit would permit the use of the subchapter S election to avoid shareholder tax on previously accumulated corporate earnings, where the corporation has ceased to conduct an active business.[1] For example, it is argued that it is improper for a corporation whose shareholders hold low-basis stock in the corporation to sell its operating assets and to invest in passive investment without the payment of the capital gains tax at the shareholder level. Because a shareholder's stock in a corporation receives a stepped-up basis upon the shareholder's death, it has been pointed out that the shareholder tax can be eliminated altogether, notwithstanding that the corporation ceased to engage in an active trade or business and had become the shareholder's investment vehicle.

Second class of stock

Another issue the Subcommittee may wish to consider is whether the present rule prohibiting a subchapter S corporation from having a second class of stock outstanding should be continued. H.R. 6055 would continue this rule. This rule limits the benefits of subchapter S status to corporations with a simple capital structure.

In deciding whether the present law prohibition against a second class of stock is appropriate, the relevant considerations include the

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[1] See, for example, Kadens, "Proposed Subchapter S Amendments—A Boon to Private Investment Corporations?" 58 Taxes 379 (June 1980).

possible complexities inherent in allocating income and losses to a second class of stock, either as income accrues, or as dividends are paid; any possible tax avoidance or tax shelter possibilities which might occur through the allocation of items to persons not bearing the economic burden (in the case of losses) or the economic benefit (in the case of gains) of these items; and possible benefits of deferring income by reason of accruing unpaid items.

If the restriction against a second class of stock is retained, a question arises whether present law (based largely on certain court decisions) should be retained or whether a new standard of reclassifying a purported debt instrument as stock in a subchapter S corporation should be developed. For example, are existing corporate tax standards appropriate for hybrid instruments held by creditors or by shareholders? Should State law be relevant, i.e., should an instrument which is treated as debt for State law purposes never disqualify a subchapter S election, even though the instrument may provide the holder principally with equity participation in the profits and assets of the corporation? Should "thin capitalization" be a relevant consideration where deductibility of interest no longer reduces the corporate tax?

Finally, the tax treatment of a reclassified debt instrument in a regular corporation (with accumulated earnings) which elects subchapter S should be considered. For example, if an instrument is no longer reclassified as equity but is treated as debt, should either the election be treated as resulting in a taxable exchange, or should a later redemption be treated as a stock redemption with possible dividend treatment?

Foreign income

Under present law, a subchapter S election terminates if, for any taxable year, more than 80 percent of the corporation's gross receipts are from sources outside the United States. H.R. 6055 continues this rule. (However, unlike present law, the bill would allow shareholders a credit for foreign taxes paid by the corporation with respect to the foreign source income permitted to be received by a subchapter S corporation.) In deciding whether it is appropriate to restrict subchapter S to corporations doing business domestically, one consideration is whether compliance problems may be created when the books and records of the corporation are overseas and not readily available for audit. Also, the subchapter S provisions must coordinate properly with provisions of treaties to which the United States is a party.

Taxable year

Present law does not limit the choice of a taxable year by a subchapter S corporation. Partnerships, on the other hand, must use the same taxable year as the principal partners unless a business purpose exists for not conforming the taxable years. These rules limit the ability to defer income. H.R. 6055 would provide a subchapter S rule generally similar to the partnership rule.

If the taxation of corporate income to the subchapter S shareholders closely parallels a "passthrough" entity system in which the shareholder or shareholders are taxed as if the assets were held directly, and

if subchapter S corporations are allowed to hold solely passive investments, the limitation on the selection of the taxable year becomes more important. For example, it may be undesirable for a taxpayer, with no business purpose, to be able to incorporate an investment portfolio of stocks and bonds and thereby defer for a year paying tax on up to eleven months of interest and dividends, by reason of the subchapter S corporation adopting a fiscal year ending on January 31 (and thereby deferring the payment of tax until the shareholder makes tax payments for its calendar year which includes that January 31).

Another important question concerns the treatment of any existing subchapter S corporation that cannot establish a business purpose for its current fiscal year. Should such a corporation be "grandfathered", and if so, for how long? H.R. 6055 would grandfather these coporations until a 50-percent change of ownership after 1982 (other than by reason of death) occurred.

V. REVENUE EFFECT

The revenue effects of this bill with respect to both amounts and timing cannot be estimated with precision. However, the net effect of the bill probably would result in a revenue loss of less than $10 million annually during the next several years.

The provisions affecting eligibility for subchapter S treatment are expected to reduce budget receipts by less than $5 million annually.

The provisions affecting election, revocation, and termination of subchapter S status are expected to have a negligible revenue effect.

The provisions dealing with treatment of income deduction and credits are expected to reduce budget receipts by a negligible amount.

The provisions dealing with treatment of corporate distributions are expected to reduce budget receipts by a negligible amount.

The provision affecting taxable year of corporations is expected to increase budget receipts by a small amount.

All other provisions are not expected to have any significant impact on budget receipts.

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